UNITED NATIONS

TD

United Nations Conference on Trade and Development

Distr.
GENERAL

TD/B/COM.2/38
19 December 2001

Original: ENGLISH

TRADE AND DEVELOPMENT BOARD
Commission on Investment, Technology and Related Financial Issues
Sixth session
Geneva, 21-25 January 2002
Item 3 of the provisional agenda

IMPACT OF INTERNATIONAL INVESTMENT FLOWS ON DEVELOPMENT: THE IMPACT OF FDI POLICIES ON INDUSTRIALIZATION, LOCAL ENTREPRENEURSHIP AND THE DEVELOPMENT OF SUPPLY CAPACITY OF DEVELOPING COUNTRIES, IN PARTICULAR THE LEAST DEVELOPED COUNTRIES

Note by the UNCTAD secretariat

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INTRODUCTION

1. In line with the decision by the Trade and Development Board at its twenty-fourth executive session on 24 March 2000, the secretariat has prepared this note on the policy considerations raised by experts at the Expert Meeting on the Impact of FDI Policies on Industrialization, Local Entrepreneurship and the Development of Supply Capacity, as set out in its Outcome.[1] The purpose of this note is to identify and comment on the policy questions posed by the experts for consideration by the Commission on Investment, Technology and Related Financial Issues at its sixth session.

2. The Outcome of the Expert Meeting was sent to member States for comments. No comments have been received, perhaps because, owing to the date of the Expert Meeting, very little time was given to member States to reply. This note therefore draws on the views of the experts as reflected in the Chairperson's summary of the discussions at the Expert Meeting, as well as on the analysis in the *World Investment Report 2001: Promoting Linkages*. The policy considerations of the Outcome of the Expert Meeting, which were identified by experts as being the most pertinent, are reproduced in full (text in italics), followed by comments and observations. The last section of the note presents proposals on future work that were put forward during the Expert Meeting.

[1] "The impact of FDI policies on industrialization, local entrepreneurship and the development of supply capacity of developing countries, in particular the least developed countries", TD/B/COM.2/EM.10/L.1.

Chapter I

POLICY CONSIDERATIONS: THE ROLE OF GOVERNMENTS

3. *Governments are encouraged to consider cost-efficient ways of promoting foreign direct investment (FDI) policies that are consistent with their country's overall development objectives and industrialization strategies, fully involving the private sector and reconciling foreign investors' motives with the country's priorities. While government leadership in providing a clear vision of a development strategy is the starting point, a public–private sector partnership is both helpful and necessary during the implementation stages.* (para. 12).

4. A growing number of countries recognize that an inflow of FDI can bring important benefits to the host country. However, it is also noted that such benefits cannot be taken for granted. The policy challenge for countries is two fold: (a) to attract the kind of investment that can add to the competitiveness of the host country's economy and production capacity; and (b) to realize the potential benefits from the inward FDI that takes place. In both cases, a clear development strategy is important in order to identify in what sectors and for what activities FDI would be most desired. Similarly, close cooperation with the private sector is required in order to enhance the understanding of corporate strategies, to identify investment opportunities and to promote beneficial impacts deriving from inward FDI. A thorough understanding of international production systems and strategies of transnational corporations (TNCs) can usefully contribute to successful implementation of industrialization and export strategies using FDI as a catalyst.

5. *Coordination among government agencies and departments, and a simplified institutional setting consisting of a lead agency for FDI promotion, are also highly recommended.* (para. 13).

6. The process of selecting locations for investment involves consideration of a large number of aspects. Typically, there is a need for cooperation among the various government institutions that play a role in providing, for example, information, licences and incentives in this process. Many countries have found it useful to appoint a single agency, either as a part of a ministry or more independently, to be responsible for the coordination of investment promotion activities. To become an efficient "one-stop-shop", investment promotion agencies need a well-functioning network both with other government actors and with those in other sectors. Such a network benefits from a strong political commitment as well as from close interaction with both domestic and foreign-owned companies in the private sector.

7. *A targeted approach is recommended in designing FDI promotion policies, as it represents the most efficient use of limited resources, offers the best prospects for success, and helps to achieve strategic goals.* (para. 14).

8. The strategies to attract FDI are evolving. In the *first generation* of investment promotion policies, countries simply liberalize their enabling frameworks for FDI to attract more investment. This continues to happen throughout the world. UNCTAD data show that in 2000 alone out of some 150 FDI regulatory changes made by 69 countries, 98 per cent

were in the direction of creating a more favourable environment for FDI. While such (in a sense passive) liberalization is important for attracting much-desired investment, it is usually not sufficient in the increasingly competitive world market for FDI. Consequently, in the *second generation* of investment promotion policies, countries actively "market" their countries as locations for FDI. This approach, which typically includes the setting up of national investment promotion agencies, has been widely adopted by developed as well as developing countries. For example, the World Association of Investment Promotion Agencies, created as recently ago as 1995, today has more than 110 members. The *third generation* of investment promotion policies adopts an enabling framework for FDI and a proactive approach towards attracting FDI as a starting point. It then proceeds to target foreign investors (in accordance with a country's developmental priorities) at the level of industries and firms and seeks to meet their specific locational needs. Although a targeted approach is difficult and takes time to develop, third-generation promotion is increasing.

9. A targeted approach is not only becoming more important for facing the growing competition in the area of investment promotion, but is also desirable from the point of view of achieving efficient use of scarce resources. Targeting may also help policy makers to improve their understanding of corporate strategies and of the specific locational assets and liabilities that are associated with their host countries. An "honest" assessment of the ability to meet the requirements of specific investors is important with regard to deciding on what activities and firms to target. There is no "one-size-fits-all" formula to apply. Instead, the approach has to take the specific circumstances of each country into account. Targeting is an ongoing process and needs to be adapted to, and to develop with, the evolving objectives (employment generation, promotion of competition, generation of exports, technology inflow or upgrading of the domestic enterprise sector) and locational capabilities of countries.

10. *To increase the beneficial leverage of FDI on the host economy, Governments need to pay special attention to developing local supplier programmes, and to upgrading the technology and capacity of local suppliers.* (para. 15).

11. Linkages with local firms and institutions constitute the best channel for diffusing skills, knowledge and technology from foreign affiliates to host economies. Such linkages can contribute to the growth of a vibrant domestic enterprise sector, which is the bedrock of economic development, and thereby to a country's supply capacity. For developing countries, the formation of backward linkages, whereby foreign affiliates purchase parts, components or services through various forms of outsourcing or subcontracting arrangements, is of particular importance.

12. Firms too have an interest in fostering linkages. Supply chain management has become critical for the competitiveness of many TNCs. For example, a manufacturing firm spends on average more than half its revenues on purchased inputs. In response, some TNCs organize special development programmes in host developing countries to assist potential or existing suppliers. The experience of various companies illustrates how companies in different industries and host countries can actively support suppliers in upgrading their technology, productivity and ability to compete internationally. However, the extent to which foreign affiliates create linkages with domestic suppliers (as opposed to, say, using imports)

is determined by the cost–benefit ratio of such efforts, as well as by differences in firm-level perceptions and strategies. The most important factors are related to corporate strategy and the availability of supply capacity. A lack of efficient domestic suppliers is a common obstacle to the creation of linkages, particularly in developing countries. Building on the basic self-interest of firms as regards backward linkages, policy makers in host countries have an important role to play in influencing the willingness of foreign affiliates to use local suppliers. In particular, they can address specific obstacles to the linkage formation process by increasing the benefits and/or reducing the costs of using domestic suppliers. For example, TNCs may be unaware of the availability of viable suppliers, or they may find it just too costly to use them as sources of inputs.

13. *Governments should examine the key elements of a linkage promotion programme, as summarized in the following steps: (a) setting the policy objectives, in line with the country's overall development strategy; (b) identifying the targets of the programme: selection of industries, foreign affiliates and domestic firms; (c) identifying the specific measures to be adopted, in terms of information and matchmaking, technology and technical assistance, training and provision of finance; and (d) setting up an institutional and administrative framework to implement and monitor the programme.* (para. 16).

14. As described in more detail in the *World Investment Report 2001*, linkage promotion policies need to be consistent with and embedded in a broad range of policies that support enterprise development and FDI promotion. Some countries – Costa Rica, the Czech Republic, Ireland, Malaysia, Singapore and the United Kingdom, for example – have, often with considerable success, set up comprehensive linkage development programmes involving a combination of different policy measures and targeting selected industries and firms. Well-targeted government support can tilt the balance in favour of more linkages and thereby contribute to transfers of knowledge from TNCs that can foster the development of a vibrant domestic enterprise sector. Of course, like other development policies, linkage promotion efforts need to be adapted to the circumstances prevailing in each host country and should be undertaken in close collaboration with the private sector and other stakeholders.

15. The starting point for an effective linkage programme is a clear vision of how FDI fits into the overall development strategy and, more specifically, a strategy to build production capacity. The vision has to be based on a clear understanding of the strengths and weaknesses of the economy and of the challenges facing it in a globalizing world. A linkage programme should in particular address the competitive needs of domestic enterprises and the implications these have for policies, private and public support institutions, and support measures (including skills and technology upgrading). It is advisable for policy makers that choose this approach to "start small" (perhaps with a pilot scheme) and to build policy monitoring, flexibility and learning into the programme. The need to start small is all the greater when resources are scarce. Moreover, it is essential for any programme to seek close collaboration with the private sector – both foreign affiliates and domestic suppliers – in design and implementation.

16. When designing a linkage promotion programme, Governments need to be aware of actions already taken by foreign affiliates and domestic firms. Some of these may need to be

encouraged and supported. Governments can act as facilitators and catalysts and ensure that private institutions have the incentives and resources needed. They can be particularly pro-active in the following key areas of linkage formation: information and matchmaking; technology upgrading; training; and access to finance. The range of measures that can be taken in each of these areas is wide. Their principal purpose is to encourage and support foreign affiliates and domestic firms in creating and deepening linkages. Specific choices depend on the results of earlier consultations with existing support institutions and relevant programmes in the public and private sectors, as well as with key stakeholders on the specific needs of an industry or set of firms. Governments could also encourage participating foreign affiliates to agree to a coaching and mentoring arrangement with promising local firms.

17. Linkage programmes can only work if they are networking effectively with efficient intermediate institutions providing support in skill building, technology development, logistics and finance. These include standards and metrology institutes, testing laboratories, research and development centres and other technical extension services, productivity and manager training centres, and financial institutions. They can be public or private. It is also important that linkage programmes work closely with relevant private associations – chambers of commerce and industry, manufacturers' associations, investors' associations and so on. Trade unions and various interest groups are other important stakeholders. Finally, it is important to have a monitoring system in place to evaluate the success of a programme. Often, in a learning-by-doing process, a programme needs to be adjusted and refined as experiences accumulate and situations change. The system could include benchmarks and surveys of users.

18. *Home countries should share experiences in targeting and linkage promotion, and assist in this respect. Improved access to developed country markets, especially for products from the least developed countries and low-income countries, can help those countries to attract FDI. Home countries are also encouraged to provide financial assistance to developing countries, particularly those with limited resources, for the establishment of an appropriate framework for FDI promotion and linkage development. Outward FDI agencies in developed countries could serve as vehicles for supporting FDI in developing countries, for example by liaising with investment promotion agencies in those countries and disseminating information.* (paras. 18-21).

19. Targeting, like linkage promotion, involves relatively sophisticated policies. It requires considerable human and financial resources. Some efforts by developing countries to attract and benefit from FDI are hampered by trade and other barriers related to economic exchange with the developed countries' markets. Against this background, Governments in the home countries of TNCs can play an important role in providing technical assistance in the area of investment promotion as well as linkage development. There is a need to improve the dissemination of information on existing investment opportunities in developing countries, particularly in the least developed countries. Outward investment promotion agencies may contribute by sharing such information with potential investors in their countries. Moreover, by opening their markets further, developing countries increase their chances of attracting export-oriented FDI. Experience has shown that developing countries or

economies in transition benefiting from preferential access to major markets have attracted substantial amounts of FDI, and sometimes, when capable local suppliers are available, rules of origin can help foster linkages.

Chapter II

POLICY CONSIDERATIONS: THE ROLE OF THE INTERNATIONAL COMMUNITY

20. *International institutions dealing with FDI should assist developing countries and countries in transition in setting up an appropriate institutional framework for FDI policies and targeting, including the formation of clusters. Cooperation and coordination among United Nations agencies and other relevant institutions on these issues are desirable. The international community should assist the least developed countries in building and improving the infrastructure necessary for attracting FDI.* (paras. 22-24).

21. Measures by individual Governments can be complemented by efforts by the international community. Examples of such efforts include the provision of training in the area of investment promotion and linkage promotion, analysis of the framework for international investment, and assistance in implementing policy measures that would enhance the competitiveness of developing countries as locations for FDI and/or would help developing countries to benefit more from inward FDI. The international community, including both the public and the private sectors, can also assist in terms of disseminating information on investment opportunities in developing countries. Special attention needs to be paid to the situation of the least developed countries in this regard.

Chapter III

PROPOSALS FOR FUTURE WORK

22. *UNCTAD should: (a) continue to analyse the international systems of production, by sector and industry, and make this information available to member countries; (b) assist developing countries in assessing their existing capabilities in order to help them define policy goals in line with their competitive situation in the international market; and (c) help developing countries to design, implement and monitor FDI targeting and linkage programmes consistent with their industrialization and development strategies.* (para. 25).